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UNCLAS SECTION 01 OF 08 CARACAS 000718

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TREASURY FOR KLINGENSMITH AND NGRANT
COMMERCE FOR 4431/MAC/WH/MCAMERON
NSC FOR DTOMLINSON
HQ SOUTHCOM ALSO FOR POLAD
ENERGY FOR CDAY, DPUMPHREY, AND ALOCKWOOD

E.O. 12958: N/A
TAGS: ECON EFIN EPET EINV ENRG VE
SUBJECT: EVERYTHING YOU EVER WANTED TO KNOW ABOUT THE
VENEZUELAN ECONOMY, BUT WERE AFRAID TO ASK

CARACAS 00000718 001.2 OF 008

SUMMARY

¶1. (SBU) The BRV is spending more money than ever before on the back of historically high oil prices. Despite these high oil prices, PDVSA appears to have cash flow problems stemming from its role as the BRV's cash cow. Official production figures exceed most analyst estimates, and PDVSA's ability to increase production is limited. PDVSA's issuance of USD 12 billion in debt in 2007 demonstrates its need for cash. Despite these problems, the BRV probably has financial resources of around USD 66 billion in off-budget and foreign exchange reserves to draw on should problems mount, and the government can always devalue if money gets too tight. The overvalued exchange rate (currently over 60 percent) allows the BRV to selectively promote certain imports and discourage others. The parallel exchange rate is augmenting inflation, which at 17 percent in 2006 was the highest in the hemisphere. Inflation is driven by government spending that has doubled since 1999 and by policies that cause shortages and keep interest rates below the rate of inflation. Despite the economic distortions, a banking crisis looks unlikely in the near term, so long as BRV spending maintains liquidity and regulations do not push banks into a corner. Government handouts and the mission social programs drive Chavez' support in the D and E classes, who have seen their incomes and living standards rise. These programs are not cost effective, however, and appear to be unsustainable. The weakness of the current system is evident in the labor force, where 400,000 people enter the labor market annually to compete for fewer than 200,000 jobs. The government taps also run full for military spending, which included over USD 4.3 billion in arms purchases since 2005. END SUMMARY.

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Is Venezuela's fiscal spending becoming unsustainable?
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¶2. (SBU) In 2006, we estimate the BRV spent approximately USD 65 billion (USD 54 billion in budgetary spending and another USD 11 billion spent by PDVSA, FONDEN, and FONDESPA). If one

extrapolates spending increases of 20 percent annually (the average increase in dollar terms over the past eight years) and assumes that inflation meets the government's target of 12 percent (which it won't), in 2007 the government will need to spend at least USD 87 billion in 2007, USD 117 billion in 2008, and USD 157 billion in 2009 (assuming no devaluation). The average price for the Venezuelan oil basket was USD 56.44/barrel in 2006 (a 350 percent increase over 1999 and a historic high) and production was approximately 2.5 million barrels/day (see paragraph 8). Production is not expected to rise and most analysts predict the price of the Venezuelan oil basket to range between USD 50 to 60/barrel in 2007. This leaves the government with the problem of stagnating revenues and increasing costs, to say nothing if the price of oil falls.

¶3. (SBU) Much like an individual, a government that begins to run out of money has three basic options: spend less, eat into savings, or incur debt. While it is likely that the BRV will augment spending at a slower rate than in recent years, it has to keep increasing spending in order to meet the rising expectations of its citizens and to cover up distortions caused by an increasingly inefficient and corrupt system.

¶4. (SBU) The BRV has approximately USD 33 billion in off-budget funds and another USD 34 billion in Foreign Exchange reserves. The lack of transparency in government accounts requires some amount of estimation in compiling these numbers. In the last quarter of 2006, the off-budget reserves fell by almost USD 2 billion, presumably due to the increase in spending in advance of the December elections. These "rainy day funds" will cushion BRV finances for some time. In fact, Minister for People's Power of Finance (MPPF) Rodrigo Cabezas recently claimed that the BRV could survive without exporting a drop of oil for 18 months. Venezuela's

external debt picture is also quite manageable, with an external debt/GDP ratio of less than 25 percent and annual external debt payments of less than USD 2.5 billion.

¶5. (SBU) While one can argue the merits of using rainy day funds and issuing debt when oil prices are at historic highs, it does nonetheless appear that the BRV can maintain these spending levels for a few years before the chickens come home to roost. A fourth option available to governments is to print more money. A devaluation, while painful to ordinary Venezuelans (by decreasing the value of their savings and generating higher inflation in a country that already has the highest inflation rate in the region), would also allow the BRV to prolong the situation by providing more bolivars for every dollar of oil revenue -- albeit at a significant cost.

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What price of oil is Venezuela's break even point?
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(see 06 CARACAS 1291 for more information)

¶6. (SBU) It is difficult to set a magic number on the price for the Venezuelan oil basket which the BRV needs to sustain its fiscal policy. It depends on the production levels of the various types of crude that make up the Venezuelan basket, as well as factors such as inflation, government spending, debt issuance, and the amount of "rainy day funds" the BRV has stored up for just such an eventuality. Conventional wisdom is that Venezuela loses USD 1 billion in revenues for each dollar drop in the price of oil. To define the break even point as the point at which BRV expenditures exceed revenues would not be illuminating, as many countries have long-term policies of deficit spending. Rather, it is important to estimate the point at which the BRV's fiscal deficit becomes so large as to force it to burn through its cash reserves and begin serious deficit spending (say in excess of 10 percent) within a one to two year time frame. The traditional number has been assumed to be around USD

40/barrel for the Venezuelan basket, though Econ contacts and local analysts provide ranges from USD 25/barrel to USD 55/barrel.

¶7. (SBU) Demands by Chavez and Minister Ramirez for emergency OPEC meetings and production cuts as the Venezuelan basket price fell below USD 45/barrel (or roughly USD 55/barrel WTI) in early 2007 imply that they see this number as a red line. On March 15, Ramirez commented that an OPEC basket price of USD 54/barrel (or roughly USD 50/barrel for the Venezuelan basket) was reasonable.

How much oil does Venezuela really produce?

(06 CARACAS 905, 1238, 1400, 2297, CARACAS 512)

¶8. (SBU) According to the Ministry of People's Power for Energy and Petroleum (MPPEP), Venezuela produces approximately 3.4 million barrels per day (mbd) of petroleum and petroleum derivatives, divided between PDVSA production (2.287mbd), the former Operating Service Agreements (OSAs) (343,000bd), PDVSA Gas (29,000bd), the Strategic Associations (SAs) in the Faja (563,000bd), and Liquefied Natural Gas (173,000bd). These numbers are optimistic; most independent analysts think that Venezuela actually produces between 2.4 and 2.6mbd. Embassy estimates, based on data from service companies and shipping firms, are that PDVSA produces around 1.6mbd, the former OSAs produce another 350,000bd (PDVSA owns on average 60 percent) and the four SAs in the Faja were producing around 520,000bd (of which PDVSA controls approximately 40 percent of production) before the 2007 OPEC cuts. This gives Venezuela a total production of around 2.45mbd, of which about 2mbd are exported.

¶9. (SBU) Our estimate tracks with other reliable observers. The Department of Energy's Energy Information Administration (EIA) estimates that Venezuela was producing 2.49mbd as of the end of December 2006, and independent local energy analysts estimate current production at 2.5mbd. This

contrasts sharply with the data published by the MPPEP as part of its annual report to the National Assembly in February 2007, which claimed that Venezuela was exporting 2.9mbd, of which 2.4mbd was wholly owned by PDVSA. Post and most analysts expect Venezuela's production to decline in the near to medium term due to increasing inefficiencies, underinvestment, and a reduction in private sector participation. This is in spite of PDVSA's USD 70 billion investment plan to raise production to 5.8mbd by 2012. PDVSA recently announced that its investment budget for 2007 would exceed USD 10 billion, or nearly double what it spent in 2006, which may be recognition of mounting production difficulties.

Is PDVSA Unable to Pay Its Bills?

(06 CARACAS 2227, 3311, 3558, CARACAS 183)

¶10. (SBU) PDVSA's finances are a black box; transparency and accountability are sorely lacking. Nonetheless, all signs indicate that PDVSA has cash flow problems. PDVSA has had trouble paying its joint venture partners, services companies, and (reportedly) even its income tax bill. The press has reported that PDVSA is offering oil instead of cash to pay for the lost equity in the conversion process for the Strategic Associations in the Faja. PDVSA's bottom line is being strained by BRV demands for more and more cash, especially for social programs, having contributed at least USD 13 billion to BRV budgetary and off-budgetary coffers in
¶2006. PDVSA's role as the BRV,s cash cow, coupled with rising costs and increasing inefficiency, is evident in its increasing costs and decreasing profits, even as revenues continue to grow on the back of high oil prices. Given

PDVSA's USD 100 billion in worldwide revenues during 2006, PDVSA looks more like a company lacking financial controls, rather than one threatened with bankruptcy. Were PDVSA ever to get into real trouble, it could in theory decrease these transfers or take steps to increase production.

¶11. (SBU) Political pressures, however, make the likelihood that PDVSA would decrease social spending unlikely. In fact, it will probably go up in 2007. PDVSA's plans to increase production frequently fail to be implemented in a timely manner. The normal time lag in increasing oil production coupled with high global demand for oil machinery and services make the ability to quickly increase production remote in the short to medium term. There is very little spare production capacity in Venezuela currently.

¶12. (SBU) PDVSA only had about USD 4 billion in debt in 2006, and investment bankers have indicated to econoffs that increasing its debt profile would not be difficult given global liquidity glut chasing returns in emerging market debt. Already in 2007, PDVSA has secured USD 4.5 billion in lines of credit and on April 12 it will issue a further USD 7.5 billion in debt, which will be the largest debt issuance in emerging market history. After this issuance, PDVSA should have between USD 15 and 16 billion in debt.

How much does the BRV have stashed away?

(06 CARACAS 3411)

¶13. (SBU) While the BRV's finances are intentionally opaque, current Embassy estimates are that the BRV had around USD 33.4 billion in available funds (as of the end of February 2007), not counting USD 34 billion in Central Bank (BCV) reserves. Much of the money in off-budget funds is already allocated, but could presumably be reallocated in a crisis. The off-budget funds are divided between treasury funds held in the BCV (USD 1.8 billion), BRV deposits in private sector banks (USD 8.7 billion in bolivars), The Bank for Social and Economic Development (BANDES) (USD 9.9 billion), The Treasury Bank (USD 5.7 billion in bolivars plus FONDEN's assets in dollars), the Fund for National Development (FONDEN) (USD 6.2 billion, held by the Treasury Bank) and the Fund for Social

and Economic Development (FONDESPA) (USD 1 billion). FONDEN has since received USD 3.7 billion in transfers from the BCV. (Note: These numbers are gleaned from BCV reports and public comments by BRV officials. There is considerable doubt as to the accuracy of BRV financial accounting and many reports are significantly late. End Note.) In addition to the rainy day funds and official reserves, PDVSA has tens of millions of dollars in escrow accounts tied to the Faja strategic associations. PDVSA can only draw on the accounts by presenting audited financial statements. It is very possible that PDVSA has additional funds held in off-shore accounts, but we have no way of verifying their existence.

What is the true exchange rate?

(06 CARACAS 1215, 3434, CARACAS 216, 493, 574)

¶14. (SBU) Virtually everyone agrees that the official exchange rate of 2150 Venezuelan Bolivars (Bs.) to the dollar is overvalued. A parallel market exists to convert bolivars to dollars using securities transactions. This so-called parallel rate is currently around Bs. 3550 to the dollar (after spiking to nearly Bs. 4500/dollar earlier in the year). It reflects a high demand for dollars driven by request denials by the Commission for the Administration of Foreign Exchange (CADIVI) (requiring firms to obtain parallel dollars to import goods or repatriate profits), excess liquidity, high internal demand from GDP growth, and capital flight. More than a quarter of the currency exchange market

in Venezuela goes through the parallel market.

¶15. (SBU) Another means of evaluating the value of the bolivar is to divide the money supply (M2) by Venezuela's foreign exchange reserves, which yields an implicit rate of Bs. 3472 to the dollar as of March 30. By just about any measure Venezuela's currency is significantly overvalued, making imports cheaper and hurting domestic production.

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Why does Venezuela maintain an overvalued exchange rate?
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¶16. (SBU) A "strong bolivar" serves as an anchor against inflation by keeping imports relatively cheap and increasing the purchasing power of the average Venezuelan. For example, Venezuela imports from 60 to 70 percent of its food, and by keeping the bolivar overvalued, foodstuffs are kept cheap in bolivar terms for Venezuelan consumers (although given that inflation for foodstuffs was over 26 percent in 2006, this clearly is not solving the BRV's problems).

¶17. (SBU) The currency controls that maintain the exchange rate also serve as a mechanism to control the importation of goods to Venezuela. Through CADIVI, the BRV can promote certain imports (by approving dollar requests at Bs. 2150/dollar) and discourage other goods (by refusing requests and forcing importers to pay Bs. 3550 for every dollar of imports). This form of Import Substitution Industrialization (ISI) also requires certificates of no production or insufficient production in order to import goods. By forcing someone to prove that the good s/he is trying to import is not produced locally, the BRV in effect protects certain local markets competition. At the same time, the overvalued official exchange rate paradoxically hurts those domestic producers by requiring them to compete with artificially cheap imports. Many firms in Venezuela have commoditized their businesses, shutting down the factory and becoming importers instead. (Comment: The arbitrariness of the exchange rate mechanism also allows the BRV to selectively deny individuals' or firms' foreign exchange requests and provides a wide avenue for corruption. End Comment.)

Will Venezuela devalue the Bolivar?

(CARACAS 568)

¶18. (SBU) Economists disagree as to whether the BRV will devalue the currency. A devaluation would bring the official and parallel markets more into line, improve the competitiveness of Venezuela's few exporting firms, and multiply the domestic spending power of the government (as most of its revenues are from oil sales in dollars). However, a devaluation would also contribute substantially to inflation (which was 17 percent in 2006) and fighting inflation is, at the moment, Chavez' prime economic concern.

¶19. (SBU) Plans are underway to create a new currency, the "Bolivar Fuerte," which would remove three zeroes from the old Bolivar, but according to MPPF Cabezas, leave its value vis a vis the dollar intact. Former Central Bank Director Maza Zavala recently argued that the conditions do not exist for Venezuela to gain from devaluation. According to Zavala, Venezuela's lack of a productive capacity which would allow for local production to replace imports or an export capacity to allow Venezuelan firms to take advantage of the cheaper currency means that devaluation would only hurt Venezuelan industry and increase the already high inflation rate. Should the BRV devalue, estimates are that the devaluation would be between 10-30 percent from the current official rate. Falling oil prices could hasten the need to devalue, as government expenditures become crimped. Post does not discount the possibility that devaluation could be hidden in

the monetary conversion scheduled for January 2008.

What is causing all of this inflation?

(06 CARACAS 2244, 2831, 3500, CARACAS 291)

¶20. (SBU) Official inflation was 17 percent in 2006 and an accumulated 3.5 percent for January and February 2007 (typically months of low inflation). Certain categories are growing faster, though, and the prices of foodstuffs and non-alcoholic beverages has increased over 30 percent in the past 12 months. Inflation in Venezuela is driven mostly by government spending, which rose 62 percent in dollar terms from 2005 to 2006, and excess liquidity. Foreign exchange controls keep people from moving their money overseas, as Venezuelans have traditionally done, and this bottleneck led to an almost 70 percent increase in liquidity (M2) in 2006 alone. As a percentage of GDP, government spending has nearly doubled since Chavez took office, going from 19.8 percent of GDP in 1999 to almost 38 percent in 2006 (when estimated off-budget spending is included).

¶21. (SBU) The increase in money on the street has not led to a commensurate increase in goods available for sale, due to inefficiencies in the economy and BRV-initiated distortions, which include price controls, fixed interest rates, and an increase in the state's role in the private sector through expropriations, nationalizations, and new regulations. Interest rates are fixed by the BRV below the rate of inflation. In maintaining political support through cheap credit, the BRV is impeded from raising rates to encourage saving and fight inflation. Inflation is predicted to continue to rise, ending 2007 somewhere between 20 and 30 percent, as more money continues to chase a limited supply of goods.

Is Venezuela in danger of a banking crisis?

(06 CARACAS 2622, CARACAS 686)

¶22. (SBU) The financial sector in Venezuela had one of its best years ever in 2006, with record revenues and profits. At the same time, banks are under constant rhetorical attack by the BRV for their "excessive profits." The BRV is not afraid to regulate to achieve its political ends: directed lending now makes up 31.5 percent of a bank's portfolio and interest rates are currently fixed, with banks having to pay depositors 6.5 percent on savings accounts, 10 percent on timed deposits, and the maximum loan rate capped at 28 percent. This spread is shrinking as the BRV continues to

lower the maximum interest rate, which is already near the rate of inflation (18.5 percent for the 12 months ending March 2007). At the same time, reserve requirements are increasing, with the statutory minimum up from 15 percent of deposits at the beginning of 2006 to 30 percent of new deposits today. These restrictions will help cushion any crisis by providing reserves to cover shortfalls, but are also forcing the banks into riskier behavior, including increasing car and home loans and credit card issuances, in order to make money. According to Banking Superintendent Diaz, only two percent of banks' portfolios are currently non-performing. High GDP growth and increasing salaries mean that their customers, for now, can pay their loans. Should government spending dry up and the economy slow down, many banks may see large increases in outperforming loans, which could potentially cause some of the banks to close.

¶23. (SBU) In addition, approximately USD 8.7 billion of Venezuelan government funds are currently deposited in the banking sector. Banks use these deposits to fund loans, even though in theory at some point the government will need this money to pay its expenses. The Treasury Bank that was

created in 2006 was designed in theory to hold all of the government's funds until they were spent. (Note: In many cases this money appears "parked" with these banks, which are rumored to pay hefty bribes to BRV officials and intermediaries for the deposits. End Note.) The Treasury Bank's assets have increased from around USD 8 billion to USD 13 billion as of December 2006 as the government has begun storing its money there. This amount is broken into the USD 9 billion the bank holds for FONDEN (in dollar and euro denominated assets abroad) and USD 4 billion or so in bolivars of budgetary money. As of yet there has not been any large scale transfer of funds out of the private banking sector; however, such a transfer could also trigger a crisis as banks would have to suddenly call in loans to avoid becoming insolvent.

Has poverty declined under Chavez?

(05 CARACAS 3830, septel)

¶24. (SBU) Reliable poverty statistics are hard to come by in Venezuela since the National Statistics Institute (INE) changed its methodology under political pressure from Chavez in late 2004. Unsurprisingly, since then, it has shown a steady decrease in the number of people living in "poverty and "extreme poverty" and is used to justify the claim that, under Chavez, poverty in Venezuela has fallen 10 percentage points, from 44 percent of the population at the end of 1998 to 34 percent of the population as of the first half of 2006 (the last date for which INE has published statistics). Households that cannot afford INE's basic basket of goods and services (USD 919 a month at the official exchange rate) are defined as "poor" and those that cannot afford the basic food basket (USD 232) are "extremely poor." The average Venezuelan household has 4.3 members. Both baskets are made up of many price controlled items, which keep the cost of the basket down, but many such items also are often sold above the legal rate or are unavailable due to recurring shortages. The comparison between 1999 and today is, of course, misleading because INE is comparing apples and oranges -- two different poverty calculations.

¶25. (SBU) Datanalisis, the largest polling and market survey firm in Venezuela, has a different method that calculates socio-economic status (SES). Their research divides Venezuela into five SES groups: A, B, C, D, and E, with A being the most well off. These groups are defined by income, education, type of housing, and geographic residency, with members of classes A and B (3 percent of the population) earning at least USD 4,000 a month, C (16 percent) earning an average of USD 900 a month, D (38 percent) averaging USD 415 a month, and E (43 percent) averaging USD 238 a month (all at the official exchange rate). Groups A, B, and C have seen real declines in their incomes of 23 percent since 1999. Group D makes about as much in real terms as it did at the

start of Chavez's presidency, and group E has seen its income rise by 14 percent in real terms during this period. The increase in earnings is coupled with the advent of the BRV "missions" that provide subsidized food, health care, and other services to these lower-income groups. Thus, at the same time that the salaries of Venezuela's poor have increased, the cost of certain goods and services has almost certainly decreased. The support of these "missions" and of Chavez is linked to the perception by members of the D and E SES groups that they are better off and that things in Venezuela are improving. This strategy of poverty alleviation via transfer payments is clearly unsustainable in the medium to long term.

Do most Venezuelans have jobs?
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septel

¶26. (SBU) According to INE, the unemployment rate in Venezuela fell from 15.3 percent in 1999 to 9.5 percent at the end of 2006. INE defines anyone working at least four hours a week as well as the participants of many of the missions as "employed." Economic researchers at the local economic consulting firm EconAnalitica estimate that over 750,000 unemployed people are considered employed due to their participation in a mission, and an additional 500,000 "employed" Venezuelans are working less than 15 hours a week and therefore would not be considered employed by international bodies like the UN.

¶27. (SBU) Estimates are that up to half of the labor force is employed in the informal sector. With around 400,000 new entrants into the job market annually, and job creation last year of only 190,000, the deficit of jobs continues to grow. In addition, the number of people considered disabled or unable to work has grown considerably since 1999. During the past seven years, the labor force grew by 21 percent and the number of disabled people almost doubled to over 1 million (or 5.5 percent of the labor force), implying the perverse incentive (hardly limited to Venezuela) for people to collect disability payments instead of seeking gainful employment. The employment situation is also marked by an increase in public sector jobs and a decrease in private sector jobs, as government spending increases and private firms reduce hiring. Thus, while it would appear that the percentage of people technically unemployed has fallen, the number of people with actual jobs seems to not have grown in tandem with the economy.

Do the Missions really make a difference?

(06 CARACAS 3505)

¶28. (SBU) By Post's count, there are currently 25 missions in Venezuela. They range from providing subsidized food (Mercal) to free health care from mostly Cuban health practitioners (Barrio Adentro), to literacy and education instruction (Robinson, Ribas, Simoncito, and others) to energy-efficient fluorescent light bulbs (Energetica), and are costing the government somewhere between USD 6-10 billion dollars a year, when funding from the national budget, FONDEN, and PDVSA is added together. The missions receive high marks in public opinion surveys, with Mercal and Barrio Adentro being the most used and most popular. While Mercal's star has faded recently due to shortages, nonetheless, 63 percent of respondents in a recent poll were positive about the program.

¶29. (SBU) A discussion of the BRV's missions requires an explanation of opportunity cost. While most all would agree that these programs do help Venezuela's lower classes, the money could arguably be spent in such a way to help many more people in an even more significant manner. The BRV's literacy programs, for example, cost USD 583 per student at the official rate and have had very little effect on reducing illiteracy. According to the Economic Commission for Latin

America and the Caribbean (CEPAL), illiteracy in Venezuela fell from 7.5 percent at the start of Chavez' term to 6 percent at the end of 2005, despite this massive spending. Most statisticians agree that most of this decline is due to population changes and not educational programs. By paying both teachers and students to participate, however, they provide a benefit to these individuals in the form of supplemental income. (Note: According to UNESCO, the average cost of a literacy program in Latin America was USD 61 per pupil in 2005 -- about one-tenth of BRV spending. End Note).

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How much money is Venezuela spending on military purchases?
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¶30. (SBU) Since 2005, Venezuela has agreed to purchase over USD 4.3 billion in military hardware and equipment. Many of these purchases are funded by FONDEN or through other off-budget means that reduce the transparency of the purchases and make tracking their actual cost and completion difficult to ascertain. Over USD 3 billion of this amount constitutes deals with Russia, which include the purchase of 100,000 AK-103 assault rifles, 24 Su-30Mk2 fighter aircraft, Spanish patrol boats, helicopters, and surface to air missile batteries. These purchases mark significant increases in military spending, which, not including these extra-budgetary purchases, only amounted to USD 3.2 billion in 2005 and USD 3.1 billion in 2006. The arms buildup has caused concern amongst Venezuela's neighbors and shows no signs of abating. In 2007, the BRV has announced that it plans to purchase additional helicopters, trainer aircraft, and submarines for at least another USD 3 billion.

BROWNFIELD